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# THE BULGARIAN ECONOMY

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## A Summary Report By the Center for Economic Development

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# OCTOBER 2008

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THIS REPORT BY the Center for Economic Development was written under especially dynamic circumstances. With the deepening crisis in the world banking system and its effect upon the world economy it has become necessary to correct part of our forecasts. Along with that, the same can be said for recent events played out domestically: some tied to the price of natural gas and its effect on Bulgarian

enterprises and citizens, others with the limiting of the flow of European funds to our country and the decision of the government to spend close to a billion and a half leva from the budget surplus. At the same time, due to the character of this report and the way in which they are gathered and calculated, the majority of objective economic and other statistical data, which are used herein, are related to the period before these unforeseeable and important events developed. Therefore, the reader will discover several differences in the mood of our analysts regarding what happened and the forecasts of that which will soon come to pass. We hope that will make the reading of this report even more interesting for you.

From the authors,  
10 October 2008



## A Summary Report By the Center for Economic Development

### *Macroeconomic Dynamics*

Our expectations of large growth in the second quarter of 2008 were born out - according to preliminary data from the NSI the total economic growth for the second quarter is 7.1 per cent. In accordance to our expectations, however, the slow down in growth of domestic consumption also continued during the 2nd quarter. Thus, the growth in individual consumption and investments for the first half slowed down (from 6.2 to 5.5 per cent and from 29.5 to 22.7 per cent, respectively). At the same time, the upward tendency in real growth of exports of goods and services (from 4.6 to 6.9 per cent for the first half) and the slowdown in the growth of imports (from 12.8 to 9.9 per cent) continued. On the supply side our expectations were fulfilled regarding the growth in the agrarian sector (6.5 per cent in comparison to a fall of 4.2 per cent from the same period last year). It is worth noting that the growth in added value in the agrarian sector is: high in comparison to weak and sporadic growth in the previous periods, not due to an abnormally minimal supply base and in a similar range of growth with the other two sectors. Added value is quickly rising in the services sector (by 7 per cent compared to 5.9 one year ago); the growth in industry slowed down (from 11.5 to 7.4 per cent), but is still the leader among the economic sectors.

The high economic activity in the country was maintained despite the NSI's business observations registering a relatively weak, but sequential ten-

dency in the fall of the overall indicator of the business climate since May. The downturn began to make itself clear in the modification of the consumer trust indicator, in the urban as well as among the rural population. The pessimism of the consumer in the present development of the economic situation in our country (around July) is growing along with her expectations for the next twelve months.

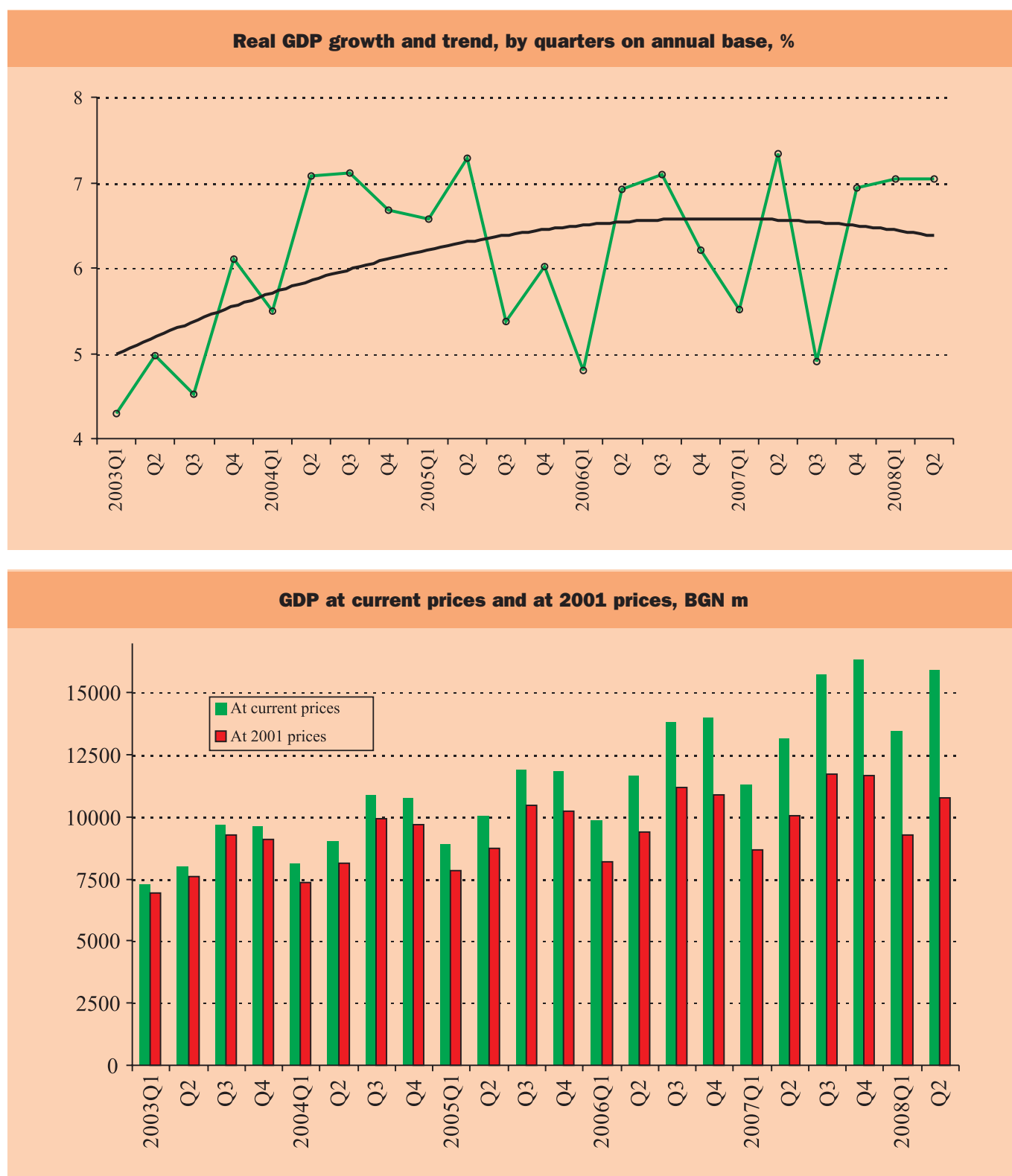
The dynamics of supply and demand for the first half and in the short-term data up until September give us cause to expect that the total economic growth for the third quarter of 2008 will be approximately 6.9 per cent, around 2 points higher in comparison to the growth from the same period last year (4.9 per cent). We expect the growth for the entire year to be approximately 6.9-7 per cent. We anticipate the recuperation of commercial agriculture continuing, while, at the same time, the growth in industry and services will slow down in comparison to a year ago.

The deficit in current accounts of the balance of payments for the country continues to grow - for the first seven months of 2008 it grew to 4.6 billion Euros and is higher by 47 per cent than that from the same period last year. The commercial balance deficit (FOB/CIF) sped up its growth and now stands at 18 per cent of the forecasted GDP. The growing import of investment products shows that local and foreign investors do not expect a crisis in manufacturing. The influx of direct foreign investment remains relatively steady despite the financial crisis

and the EU's negative report. The interest of foreign investors is stimulated by good macroeconomic and budget indicators, unrealized potential in the market, the appearance of new areas of investor interest and the tighter opportunities for a good return in other markets.

According to the latest (July) observation of consumers, worrying feelings and expectations continue to be registered regarding the rise in consumer prices. On the other hand, business questionnaires from the NSI in September outline the lack of internal inflationary pressure for price movements up to the end of 2008; the most optimistic being the services field, where 68 per cent of those responding did not foresee a change in prices during the next few months, while 22 per cent expected a reduction. The dynamics of domestic prices until now, like the positive data in the agrarian sector during the second quarter, are a reason for us not to expect pressure on inflation related to food products (figure 2). We can expect more surprises in relation to fuels as they counteract with market inflation mostly due to the ever unpredictable dynamic of their international and, respectively, domestic prices. The change in controlled prices during July and August led to a relatively higher cumulative inflation rate (6.3 per cent for August versus December last year). Further increases in the administratively controlled prices are foreseen and likely in the coming months. By the end of this year we can expect cumulative inflation to be in the range of 8-9 per cent.

Figure 1. GDP



Source: NSI, National accounts

Employment continues to grow. The number of people employed in the economy for the 2nd quarter of 2008 increased by 3.7 per cent according to NSI data from the observation of the work force and by 3.4 per cent according to NSI data from state calculations in comparison to the same period in 2007.

Total unemployment is decreasing, but among youth it is growing, while the number of people enduring lengthy

unemployment decreased significantly. The total number of unemployed individuals for the second quarter of 2008, determined by observations of the work force, has decreased on an annual basis by 12.9 per cent and the coefficient

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cient of unemployment from 6.8 to 5.8 per cent (the portion of unemployed as part of the economically active population from the age of 15 years and older). The unemployment among the young, however, has worsened from 12.6 to 13.1 per cent of the economically active in this age group (15-24 years old). Half of all the unemployed are long-term, but the tendency is for their number to decrease - and faster than overall unemployment. Registered unemployment also continues to decrease. According to data from the Agency for Employment the coefficient is now below 6 per cent for June and July.

For the first and second quarters of 2008, the growth in the number of the employed and work hours performed within the economy is speeding up compared to the growth seen one year ago. However, at the same time, the real growth of productivity increased only during the first quarter (from 2.5 per cent to 3.6) and slowed down during the second quarter (from 6.8 to 4 per cent) as compared to the growth of one year ago, which is an indication of a certain worsening of the quality of the overall economic growth.

#### *Enterprise Policy*

According to the entrepreneurs no serious improvement has been achieved in the business environment as yet, in regards to some of its elements, rather a worsening is present - having in mind the incidence of corrupt practices. In September the World Bank presented the results of the latest research on the business climate in 181 countries (Doing Business 2008). Bulgaria was placed at 45th, outdoing Romania (47) and some other states, which are members of the EU - Slovenia (54), Poland (76) and Italy (65), in the classification of overall conditions for realization of business. The relatively favorable position for Bulgaria is mostly due to the implementation of the electronic Commercial Register and a significant easing of the procedures for starting a business. In the data of the international rating agency, Moody's Investors Service, for September Bulgaria's credit rating was lowered from "positive" to "stable". The experts point out that the potential for improvement over the next 18 months has worsened due to Bulgaria's foreign

disbalance. A risk of a slowdown in economic growth exists as a result of the spread of the global financial crisis.

Discussions regarding the improvement of the business environment continue within the country - during September a series of debates on the lightening of the regulatory regime were conducted. Regardless of these discussions, the analyses and formulated suggestions over the last three years, no change was seen in practice in these regimes. Measures were taken in the area of encouraging exports - at the end of July the new export strategy for the country was officially presented. It has the creation of a favorable business environment for the development of export-oriented manufacturing as its goal, along with the meaningful increase in the level of exports and the improvement of the commercial balance. The debate continues in the Parliament regarding the bill for the change in the Law on Public Procurement. By the end of July the Parliament had only approved the first version of the suggested changes. The goal of the bill is to perfect the standardized regulation for public procurement.

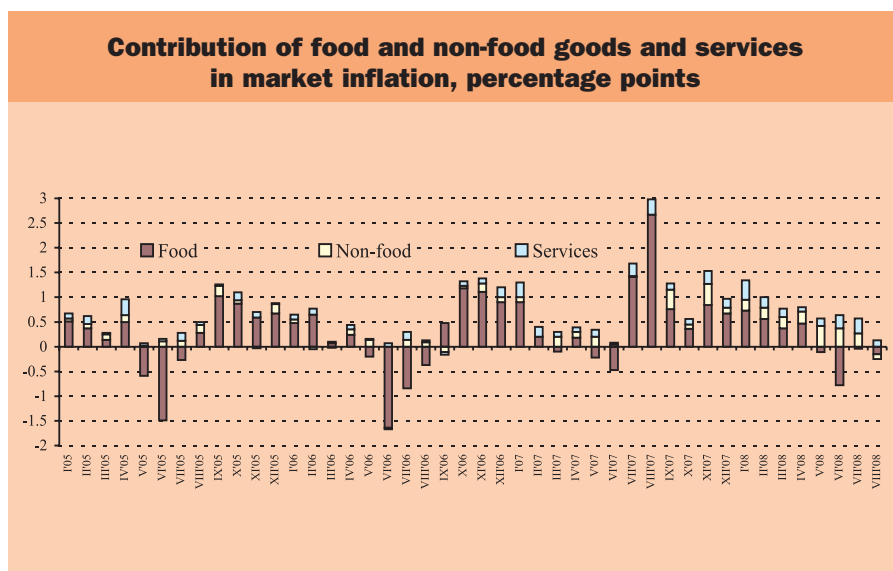
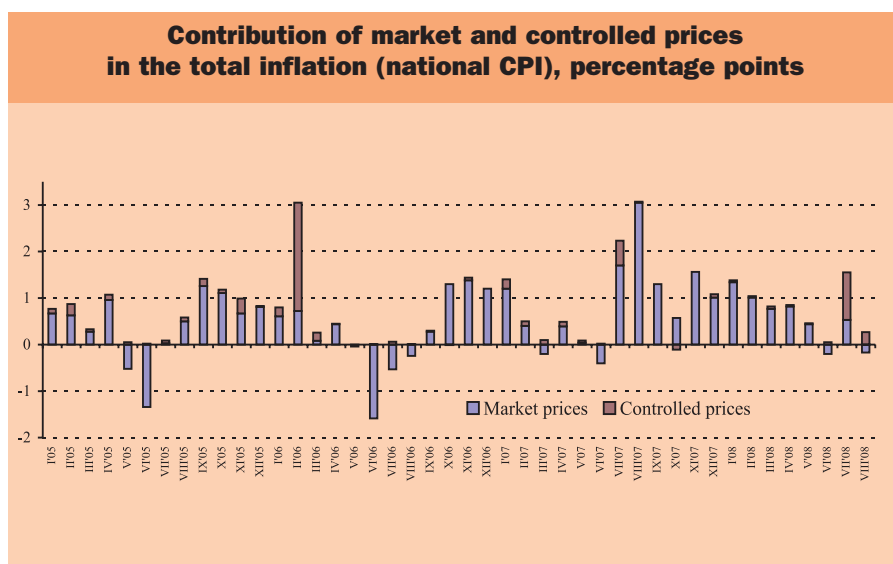
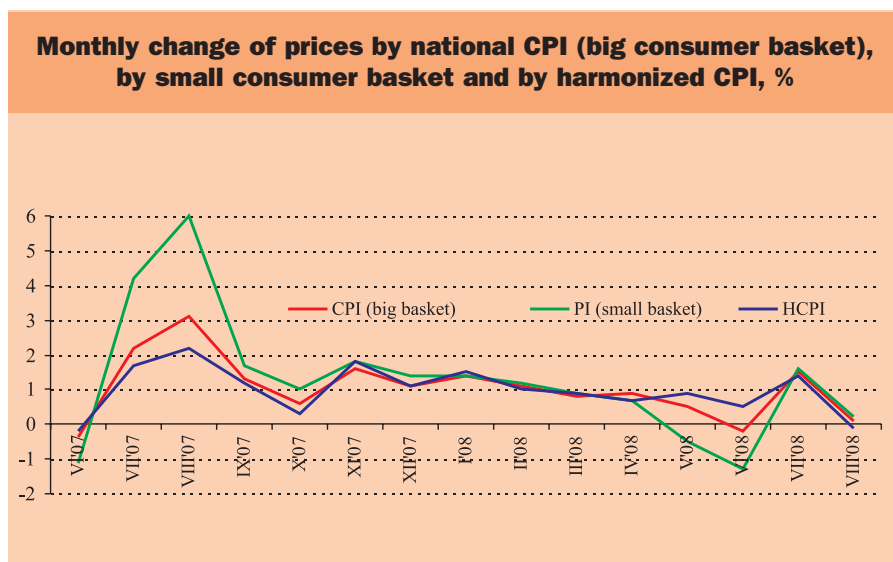
Corruption continues to be among the most serious problems. The Report of the EC presented in July noted that the advances in the areas of judicial reform, the battle against corruption and organized crime has been slower and more limited than was expected. The evaluation of the spread of corruption was negative in the annual report, Index of the Perception of Corruption for 2008, prepared by international NGO Transparency International also. Bulgaria is among the countries, which registered a serious fall in the evaluation of the level of corruption during 2008 and is down in 72nd place out of a total of 180 countries researched. Among the 31 countries of the EU and Western Europe, Bulgaria is determined to be the most corrupt. In answer to the criticism of the Annual Report of the EC in August the government approved a schedule of 80 urgent measures and actions for the period from August to December of 2008 with the goal of overcoming the noted weaknesses in the areas of judicial reform and the battles against corruption and organized crime.

Privatization continues to be implemented in the absence of serious resources. Due to changes in the Law for Privatization and Post-Privatization Control the so-called "prohibited list" of corporations not liable to privatization was not liquidated. The government supports the inclusion on this list of corporations, which do not have any serious influence on the economy, are not structure determining, and the continuation of the state's stake in them has significance solely as participation in the administration and maintaining of the material capital. Indications of an intention on the part of the government to come up with a competitive energy sector are absent from the management program. Energy corporations are not offered for sale with the exception of a few hydro-electric plants. The state policy to maintain the monopoly in the sector is a hindrance to the liberalization of energy. The newly created energy holding will distort the market to an even greater extent. The awarding of concessions for highways, airports and ports has been blocked.

#### *Public Finances*

The budget surplus over the first seven months of 2008 reached 4, 219. 1 million leva and is 74.4 per cent greater than the same period from last year. The fiscal reserves for the same period come to 10.8 billion leva, marking an increase of 46.5 per cent on an annual basis. Direct taxation by July 2008 came out to 2.9 billion leva or 62.9 per cent of that predicted for the year and, in comparison with July 2007, when that figure was 78.9 per cent of predictions. The expectation is for low tax rates to continue to exert favorable influence in the direction of increased investments, improvement of economic activity, decrease in the gray economy and increase in the income in the budget from corporate taxes. Regarding corporate taxation the fulfillment of annual predictions for 2008 reached 73.4 per cent. The fulfillment from a year earlier was 92.5 per cent. The non-tax income in the budget of the Republic reached 1. 6 billion leva, which represents 103.3 per cent of that which was foreseen in the Budget 2008. Of all the budget expenditures, those from capital continue to have the lowest percent of ful- ►

Figure 2. Consumer prices



Source: NSI, Prices; AEAF, Recent Developments Analyses

fillment. In relation to July of the previous year they marked an increase of 8.4 per cent and represent 27.1 per cent of the total planned for 2008. The Foreign State and State-guaranteed Debt toward the end of August 2008 noted a fall of around 0.4 billion Euros as compared to the level in August of 2007 and comes out to 3.813 billion Euros.

#### Social and Health Policy

The positive trend in employment, which is mainly a result of favorable macroeconomic factors in the labor market, continues. The syndicates and employers agreed to an increase of 26.6 per cent in the minimum level for salaries. For the second year in succession the budget surplus will be used for social goals. On October 1, 2008 the new, higher levels of pensions for seniority and age take effect. The debate over reform continues regarding the distribution of the weight of social security among workers, employers and the state budget, which must take effect next year; the main change remains the portion of the state as a fixed rate. The government has prepared a proposed law for the Silver Fund. Changes have been accepted in the legislation, which made it possible for the privatization of medical establishments. The ruling coalition was unable to reach a consensus on the specific parameters of health reform and the de-monopolization of the National Health Insurance Fund.

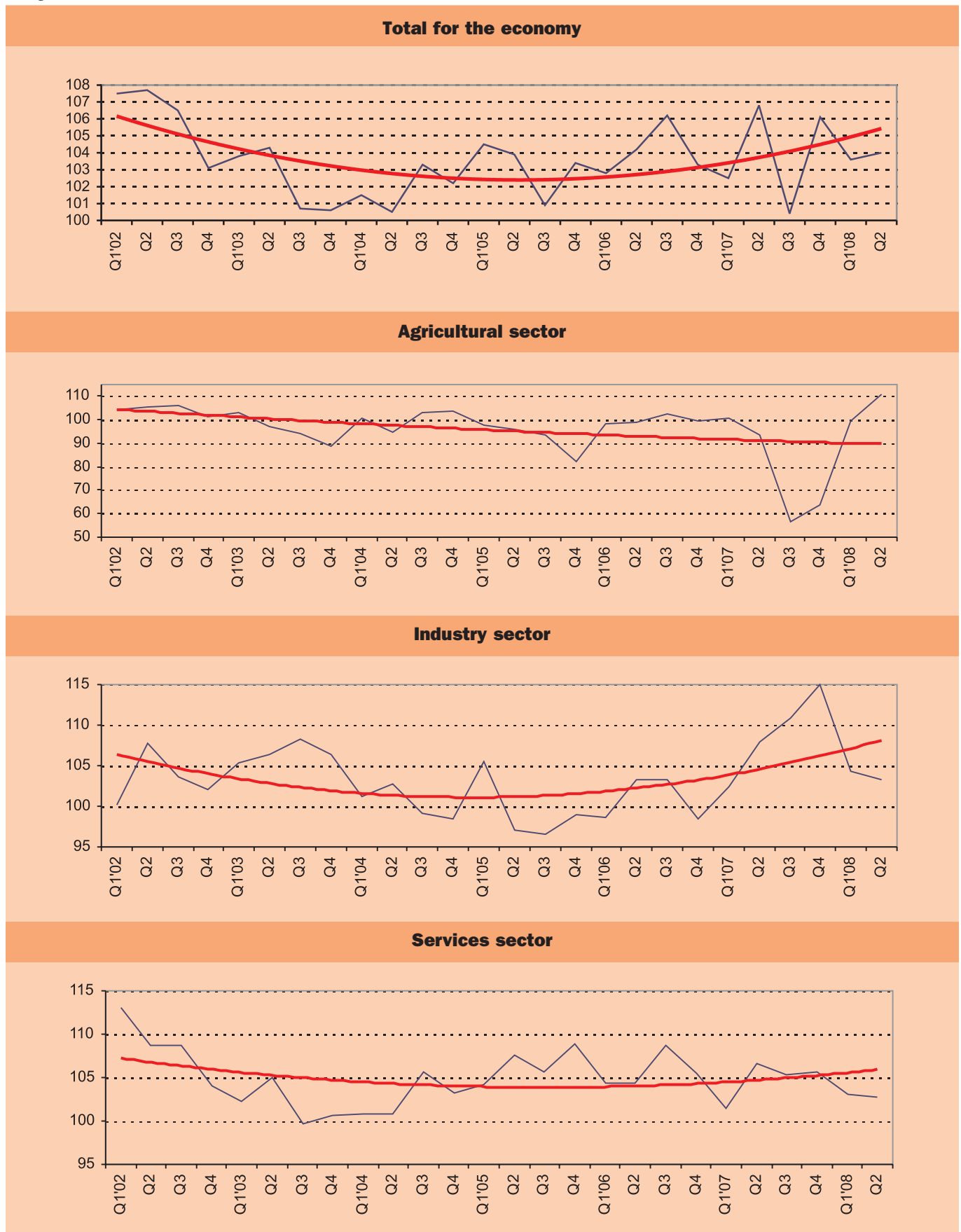
#### Ecological Policy

The Ministry of Environment and Water publically presented its goals for the updated National Waste Management Program for 2009-2013. The Operational Program Environment was started successfully. Realistic possibilities for the participation of Bulgarian companies in its implementation were outlined via the project to construct 131 recycling stations and the modernization of the existing installations in 91 municipalities around the country. The country is not in a condition to keep the time frames required by the EC regarding waste.

The European Commission suggested a revision in the ordinances related to substations, which deplete the ozone layer. Debates are ongoing ▶



Figure 3. Labour productivity, index of real growth at annual base, %



Source: NSI, National accounts

here regarding a bill to modify and supplement the Clean Air Act. The EC approved the National Plan for the Allocation of Emissions Quotas for 2007, with which the outline for trade in greenhouse gases began. Bulgaria's position on the suggestion of the European Commission regarding the Climate and Energy program was officially presented. The EC made public preparation of a methodology for ascertaining which industries will receive the right to free emissions' rights at the commencement of the European carbon market in 2013. The methodology for forecasting greenhouse gas emissions domestically for 2010, 2015 and 2020 was worked up by the MEW.

#### *Financial System*

Monetary supply toward August 2008 was growing, but more slowly. The main factors for the growth are the increase in household and corporate incomes and the flow of foreign capital. The slowdown in growth is due to the stabilization of transactional monetary demand. In August 2008 the average interest percentage on all credits increased its upward pace on an annual basis. The interest on credits up to 1 million Euros increased by 1.46 percentage points, on credits over 1 million Euros - by 0.78 percentage points, on all consumer credits - by 1.79 percentage points and on home loans by 0.94 percentage points. The interest rates on deposits also grew. We observed a certain slowing in this upward pace both for deposits in foreign currencies as well as deposits in leva.

The banking system as of July 2008 noted growth in regard to the size of funds and capital attracted by banks and a decrease in bonds and monetary instruments. The liquidity of the banking system as of the end of July guarantees a satisfactory backing of the resources attracted. In its annual report for 2007 The Deposit Insurance Fund pointed out the presence of symptoms for future problems regarding a portion of the receivables of the banks. The main message is for the banks to be careful when approving risky credit.

During the first half of 2008 the income of the insurance corporations came out to approximately 856.6 million leva, which represents growth of

22.3 per cent annually. The recorded premiums in the area of general insurance have increased by 21.3 per cent compared to the same period last year and in life insurance by 27.9 per cent. The income from life insurance increased mostly via "Life" policies and private means while, for general insurance, the greatest contributions continue to be in auto insurance, which has the largest market share in general insurance. Mergers in the sector continue to decrease for general as well as life insurers.

The global financial crisis, which began more than a year ago on the international markets and brought repercussions to the Bulgarian capital market, reached its apex in the third quarter of 2008. It was caused to a large extent, by a wave of bankruptcies of large financial institutions, which, in turn, destroyed investor trust and led to even more serious withdraw of various private groups from the market. As a result, every significant international market recorded very strong volatility during the period. At times, movements of more than 5 per cent were not unknown on the main indices. The large markets in Western Europe, however, did not fall so far as, to some extent, they succeeded in compensating the downward movements with opposite, although not so drastic, rises. The Bulgarian market, however, for the fourth quarter in succession continued to contract. Active participants in the market continued to decrease. The actual volume fell by 39 per cent compared to the second quarter and by nearly 70 per cent compared to the same period last year. The stock indices also fell with a similar pace; SOFIX passed the considerable psychological barrier of 1000 points, losing another 26 per cent compared to the end of June.

#### *Energy*

The price increase for natural gas will be in two stages. The government declared the beginning of the second Bulgarian nuclear power plant and the search for a solution for Toplofikatsia (Heating) Sofia. By the end of September 2009 the Energy Efficiency for Municipal Buildings project should be completed. It was signed between 9 Bulgarian municipalities and the MEE. The final date for the construc-

tion of replacement power at the Maritsa East 1 thermal power plant site was extended along with the accompanying de-sulphurization installations. After Turkmenistan and Azerbaijan refused to join the Nabuko project. The MEE announced Bulgaria's support of the Hungarian initiative, New Europe Transmission System (NETS), as an alternative for the transshipment of natural gas from Azerbaijan. Kazakhstan froze construction on the Ceyhan oil refinery and, thus, delayed its participation in the Burgas-Alexandroupolis project.

#### *Transport*

The European Commission rescinded the cautionary clause regarding the security of Bulgarian air transportation. An agreement was reached for a loan between Bulgaria and Japan for the construction of container terminals in Varna and Burgas. The European Commission discontinued aid in the amount of hundreds of millions of Euros to Bulgaria, stopped access to financial instruments and discontinued accreditation of the National Roadways Infrastructure Fund. Problems with Turkish carriers. The Operational Program Transport continues its activity. Contracts have been signed regarding technical support for ISPA.

#### *Construction and Real Estate*

This conjuncture in the construction field remains relatively favorable despite the September composite indicator "business climate in construction" decreasing by 4.9 points compared to August. The number of building permits grew in the second quarter by approximately 20 per cent compared to the previous quarter. In comparison with the same period last year, however, there was a fall of 7 per cent.

The supply of residential properties exceeds demand by a rate of 1.5-2 times; a serious segment differentiation is observable in the market, which more and more is determined by the interests and requirements of the buyer. The rise in interest on credits will continue to pressure the real estate market. Financing the purchase of existing properties will be ever more difficult according to credit specialists. The supply of vacation properties exceeds demand many times;



stagnation is present in this segment and investments in a so-called second home look to be the most risky.

The rise in demand for Class A business areas in good locations and the slowdown in completion of new office buildings led to an almost 100 per cent occupancy of areas on offer at the moment in Sofia. A way out of this situation is expected during 2009, when the market will welcome the appearance of the newly constructed office centers. The tendency toward the development of commercial centers continues not only in the big cities, but also in the smaller ones throughout the country. The prices for commercial lots in this segment remain steady for now.

#### *High-tech and Communications*

The regime for registering a domain on.bg has been eased. It is expected that the annual growth on the IT market in Bulgaria will be over 20 per cent. A National Center for Super-computer Applications was opened. The Communications Regulation Commission (CRC) published projects from the market analysis in the field of electronic communications.

#### *Tourism*

The evaluations of tourism continue to be contradictory - according to some, tourism is developing successfully and according to others, it is stagnant (basis for this fact is the growth in capital material of 8-9 per cent annually while the income increased by 4-5 per cent). There are experts in the field, who consider that tourism is in a crisis and headed downward. The reason for the lack of unanimity in evaluations is tied to the lack of a clear vision for direction and priorities in the sector, the absence of a strategy and ineffective advertising and marketing. During the first half of 2008 foreign citizens, who visited Bulgaria, were 18 per cent more than the same period the previous year. Close to 3.2 million foreign citizens entered the country and more than half, 1.8 million, arrived for the purpose of tourism. During the period mentioned the most significant increase in guests was from Macedonia (66.7 per cent); the number of Russian tourists increased by close to one third and Romanians, by 26 per cent. The

increase was weaker among German tourists (approximately 11 per cent) and Britons (5.4 per cent). During the first half of 2008 Bulgarian citizens travelling abroad increased tangibly (by 42.3 per cent) as compared to the same period of 2007. Bulgarians travelling beyond their borders numbered 2.9 million, of which 873, 204 for the purpose of tourism. The greatest growth was in the number travelling to Romania, approximately triple, and to Greece - more than double.

During the second quarter of 2008 the income from overnights at a means of shelter and places of accommodation increased by 9 per cent compared to the same period from 2007. According to data from NSI, 2, 643 "means of shelter and places of accommodation" operate in the country. Means of shelter and places of accommodation increased by 127 in number. A serious disagreement exists between the data provided by the NSI and the information from the branch's organizers. According to experts from these organizations the real number of sites for accommodations, of the beds in them and the income is many times greater. The reasons for the serious differences are tied to the lack of real information on beds in hotels, occupancy, the average price of a night's stay, market share, etc. A large portion of investors in tourism hide revenue or don't pay taxes. According to experts the "gray economy" in the tourism sector varies between 50 and 60 per cent. The problems could be solved by changes in the Tourism Act as well as by introducing satellite accounts in tourism.

#### *Agriculture*

The good climatic conditions during the year, the rise in food prices on an international scale and the efforts of farmers to optimize production in unison with the general conditions of the European market gave a strong stimulus to development in the branch. The agrarian sector showed real growth in added value, by 6.5 per cent in the first half and by 11.7 per cent in the second quarter in light of a corresponding fall of 4.2 per cent for the first half and 6.9 per cent for the second quarter of last year. Thus, during the first half, the share of this sector as a part of GDP reached 5.2 per cent and 6.3 per cent

of GVA in light of corresponding 4.5 and 5.6 per cent one year earlier.

The protests of stock breeders once again brought up the question of a lack of strategy for development and a clear vision for the future of the branch - protection from bankruptcy for small farms without initiative and plans for the building of highly productive breeding, which ensures a satisfactory volume of quality product. It is obvious that the common European policies are unchangingly directed toward the stimulation of the development of large-scale, highly effective agriculture, which answers to all the requirements regarding product quality and good work conditions.

Although slow and difficult, the process of scaling the sector up has begun - the number of registered farmers has decreased, yet the amount of arable land has increased as has the share of medium-sized farms with up to 4000 dka workable land; the process is also stimulated by the means of granting Euro subsidies, meant for assistance in stability and effective development of agriculture.

The requirements of the market and of modern agriculture move more and more farms toward a closed cycle (production, preservation, trade, processing). The increasing prices of food products in connection with their shortage on a worldwide scale and the widening production of biofuels will likely increase the demand for land, will stimulate trade in land and will attract more investments in agriculture, as well as allowing the increase of arable plots and decrease in untilled land. The difficulties in the real estate market act in the same direction as one can observe the tendency of investors to change their sights toward purchasing agricultural land as an investment. Land in the country remains an undervalued commodity compared to neighboring countries and in the framework of the tendencies of the total market toward gradual evening of prices. Future direct foreign investments in the growing of energy crops can be expected in connection with the planned EU requirements regarding shares of renewable sources in the production of electricity. The interest in use of organic food is growing, not only in Europe, but also at home and

the farmers are beginning to increase the areas for growing ecologically clean foods (strawberries, raspberries, cultivated forest fruits, herbs), as well as essential cultures. The number of certified producers is growing; their production is diversifying as they include tomatoes, cucumbers, peaches and projects in stock breeding.

#### *Regional Policy. European Funds*

In answer to the criticism from the EC the government accepted a detailed report and plan for overcoming the problems in working with the European funds. In the report an overview was made of the condition of absorption of funds as well as of the structure and cohesion funds. Measures were pointed out, which were accepted in May of 2008, those, which will be fulfilled by the end of 2008 and actions, which will be realized by June 2009. The positive moments in the report are tied to the following circumstances: changes in the Law on Public Procurement are foreseen with the goal of greater transparency; acceptance of a law

concerning conflict of interests is foreseen; measures are suggested for the support of administrative capacity of state workers; concrete measures are laid out for the significant improvement of the management of funds in the Operational Programs Transport and Regional Development. There are other moments in the report, however, which are not clarified enough - time frames are lacking for the acceptance of changes in legislation; concrete measures are lacking regarding the cooperation with the Attorney General; too much centralization is foreseen in the activities of planning, management, observation and control of the funds from the EU; measures to guarantee the independence of the agencies executing the programs is lacking; measures for the improvement of the coordination between ministries and between the central, regional and local authorities are absent. A decision was made to create a Civil Council of Experts for control over the expenditure of EU funds. The goal is the exercising of stricter control and monitoring of this

process.

In June 2008 the EC temporarily stopped the intermediate payments on two other infrastructure projects, financed by the cohesion fund - the Luilin-Sofia Ring Road Highway up to the Daskalovo Fork and the Technical Aid for the Preparation of Road Projects of the Trans-European Transportation Network in Bulgaria. The first contracts with the beneficiaries of the procedures for provision of free financial assistance for small and medium business announced at the end of last year were signed with a total worth of 66.5 million leva from the Operational Program Development of Competitiveness of the Bulgarian Economy 2007-2013. The MRDPW signed a contract with 50 Bulgarian municipalities for finances via the Operational Program Regional Development with a total worth of over 180 million Euros. The projects were written mostly for the construction of road infrastructure, the improvement of the condition of the municipal network in the areas of education and social work. ■

#### **Advertorial**

## **WARM COATS FOR COLD DAYS**

IN THE SHORT COLD DAYS the coat to be worn by gentlemen is of medium length and the fabric is either wool or cashmere. According to Andrews/Fashion Studio the warm winter coat is a can't-do-without accessory to men's wear. In their trademark style, the designers offer a variety of nuances and shapes. A coat is a long-term investment which adds style to your everyday clothes and makes your evening dress simply fascinating. The color scheme is the classic one - black, graphite and brown. The fashion studio designers stick to the golden rule saying that "luxury is found in small details". Collars are double and made from leather or velvet - the craze of the season; buttons are in a one line arrangement or hidden and pockets are external. Thicker and more elegant cotton jackets come as an alternative to the coat and are in warm brown colors.



There is also something for the gentlemen in favor of the sporty dress style. Andrews/Fashion Studio offers sports jackets for young people, which are appropriate for men's everyday style. The more extravagant gentlemen can choose raincoats of water-repellent material. The trademark belts are of high quality leather. The other accessories matching the offered designs are classic and sporty. The designers have come up with an interesting arrangement of fringes and metal buttons. Scarves are seen as the appropriate accessory to the coat in the winter season. Andrews/Fashion Studio relies on colorful scarves which speak of style and elegance.

The message sent to gentlemen is that they should keep their individuality, be elegant and, at the same time, not forget to rely on their masculine and self-confident look. These are the steps to lead you to your own style. ■